AGRICULTURE IN A WORLD OF TRADING BLOCS

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The past few years has seen a growing concern with the prospect of a weakening of the multilateral trading system and he emergence of a small number of regional trade blocs. The fear is that . se blocs would develop protectionist tendencies toward each other, and thus force independent countries to take shelter within a regional bloc. The benefits from a broad multilateral trade system would inevitably be forgone, though trade could still stay "open" within the blocs. The growth of regionalism is indeed evident in many parts of the world, and the further delays that have overtaken the completion of the Uruguay Round of GATT negotiations are enough to give any supporter of multilateral trade cause for concern. But the drift towards a world of trading blocs has not so far progressed to the "point of no return". Much will depend upon the behavior of the blocs themselves in the next few years.

The issue of the treatment of agriculture in a world of trading blocs is likely to become more important if these blocs come to dominate world trade. If this happens then world markets will be strongly influenced by the external trade policies of the bloc countries. There are reasons to believe that such blocs will tend to adopt uniform policies toward third countries even if they remain free-trade areas rather than customs unions. But even if the trade blocs remain subsidiary to the multilateral trade system, the treatment of agriculture and agricultural policy within the blocs is of interest. There to one can point to

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dynamic forces tending to shape policy actions.

Agriculture is treated in various ways in trading blocs and free-trade areas. In some it is ignored, as if not really subject to the same set of circumstances as other sectors. In rare cases it is treated as a regular sector of the economy, and subject to the same rules. In most cases countries have trod carefully in framing arrangements for free-trade areas so as to preserve as much as possible of the domestic autonomy of farm and food policies. Nevertheless the agricultural sector is bound to be affected by the existence of free trade with neighboring countries. The only issue is whether policies will react quickly to take advantage of possibilities that freer regional trade brings, or whether governments will resist until the policies are modified by market pressures or collapse under their own weight.

This issue of the evolution of domestic policies in free-trade areas is in turn crucial to the interests of independent countries selling into world markets for agricultural produce. If the blocs pursue aggressive policies toward each other in other aspects of trade, their agricultural trade relations are unlikely to be liberal. And if each country were to keep its own restrictive agricultural policy in the face of otherwise open intra-bloc trade policies, it is not clear what scope would exist for global negotiations on types and levels of support. If, on the other hand, domestic policies became modified as a result of internal trade developments within the blocs then the international implications could be benign. Indeed one could imagine a path to liberal international markets passing through regionally liberalised agricultural policies brought about by the forces of regional market integration.

This paper attempts to explore this path by considering the interaction between agricultural policies and free-trade areas. As a structural device, the argument is focussed on eight propositions. These include two propositions on the nature of trade blocs, followed by three on the implications for agricultural policy within the blocs and two on the implications for world commodity trade. No attempt is made to match the propositions with actual policy developments, though that would be an interesting next step.

Proposition 1: Free Trade Areas Are the Norm rather than the Exception in World Trade

There is a sometimes a tendency to think of free-trade areas as being of recent origin, or as affecting only a few countries. To put the prevalence of such arrangements in perspective, it is useful to recall how many countries are members of regional trade alliances. The most significant current free-trade areas are listed, together with their member countries, in Table 1. The 115 countries on the list include most of the Contracting Parties of the GATT, as well as a handful that are not GATT members.[1] The regions that are almost entirely covered by FTAs are Africa, Europe and the Americas; by contrast Asia and the former Soviet Bloc have not (yet) developed regional trade associations to the same extent.

The trend toward regional trade liberalisation has proceeded farthest in

[1] One country, Mauritania, is a member of two free-trade areas (ECOWAS and the Arab Common Market). The Table does not include preference schemes, such as the Lome Convention between the EC and the African, Caribbean and Pacific (ACP) countries and the Caribbean Basin Initiative (CBI) of the US. The EC itself is included as a part of the European Economic Area, formed between the EC and EFTA. Switzerland has not ratified the EEA Treaty. Not all the FTAs in the list are equally effective, but all have been actively used in recent years as a vehicle for freer regional trade on a multicommodity basis. Many have plans for tariff harmonisation, and some aim to liberalise capital and labor flows. In general the FTAs listed here do not plan full economic or political integration.

Table 1

COUNTRY MEMBERSHIP OF MAJOR FREE TRADE AREAS, 1992*

EUROPE	AMERICAS		AFRICA		ASIA/PACIFIC	MIDDLE EAST
EEA	NAFTA	AP	ECOWAS	PTA	ASEAN	ACM
Austria	Canada	Bolivia	Benin	Angola	Brunei	Egypt
Belgium	Mexico	Colombia	Burkina Faso	Burundi	Indonesia	Iraq
Denmark	USA	Ecuador	Cape Verde	Botswana	Malaysia	Jordan
Finland		Peru	Cote d'Ivoire	Comoros	Philippines	Libya
France	CACM	Venezuela	Gambia	Djibouti	Singapore	Mauritania
Germany			Ghana	Ethiopia	Thailand	Sudan
Greece	Costa Rica	Mercosur	Guinea	Kenya		Syria
Iceland	El Salvador		Guinea Bissau	Lesotho		Yemen (Dem)
Ireland	Guatemala	Argentina	Liberia	Madagascar		
Italy	Honduras	Brazil	Mali	Malawi	CER	
Luxembourg	Nicaragua	Paraguay	Mauritania	Mauritius		
Netherlands		Uruguay	Niger	Mozambique	Australia	
Norway	CARICOM		Nigeria	Rwanda	New Zealand	
Portugal			Senegal	Seychelles		
Spain	Antigua/Barbados		Sierra Leone	Somalia		
Sweden	Bahamas		Togo	Swaziland		
United Kingdom	Barbados		CEEAC	Tanzania		
	Belize		Burundi	Uganda		
	Dominica		Cameroon	Zambia		
	Grenada		Central African Republic	Zimbabwe		
	Guyana		Chad	SACU		
	Jamaica		Congo	Botswana		
	Montserrat		Equitorial Guinea	Lesotho		
	St Kitts/Nevis		Gabon	Nambia		
	St Lucia		Rwanda	South Africa		
	St Vincent and The Grenadines		Sao Tome and Principe	Swaziland		
	Trinidad/Tobago		Zaire			

* Bilateral preference arrangements are excluded

Key:
- ACM = Arab Common Market
- AP = Andean Pact
- ASEAN = Association of SouthEast Asian Nations
- CACM = Central American Common Market
- CARICOM = Caribbean Common Market
- CEEAC = Economic Community of Central African States
- CER = Closer Economic Relations Agreement
- ECOWAS = Economic Community of West African States
- EEA = European Economic Area
- MERCOSUR = Southern Cone Common Market
- NAFTA = North American Free Trade Agreement
- PTA = Eastern Southern Africa Preferential Trade Agreement
- SACU = South African Customs Union

Europe, where a large and seamless "internal market" will largely be in place by early 1993. The negotiation of a European Economic Area which includes the EC and the EFTA countries, and of Association agreements with Poland, Hungary and the Czech and Slovak Republics, effectively sets up an economic group of over twenty countries. North America is following hard behind, with the North American Free Trade Agreement between Mexico, Canada and the US, which builds upon the earlier Canada-US Free Trade Agreement and promises a tariff-free zone for most commodities over a ten year period.

Prompted by these regional activities, several regional schemes have been revived or formed in Latin America and in Africa.[2] In Latin America, the formation of MERCOSUR among the Southern Cone countries (excluding Chile), and the decision by the Andean Pact countries to form an Andean Common Market by 1995, has strengthened the often shaky level of economic cooperation in this region.[3] The countries of the Central American Common Market have signed a framework agreement for free trade with Mexico by 1996, and can be expected to negotiate terms with the other NAFTA countries. Among those facing a less certain future are the CARICOM countries, many of whom have preferential access to the US through the CBI and to the EC through the Lome Convention, who face the prospect of an erosion of those preferences. These countries may also be obliged to join a widened NAFTA to remain in contention for investment funds and to keep access to the US market.

In Africa, riddled with regional trade agreements since the colonial days,

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[2] Many regional trade groups were founded among developing countries in the 1960's, in part as a response to the establishment of the EC. This current resurgence of interest can be traced to the renewed activity in Europe following the publication of the Single Market White Paper in 1985.

[3] Chile has opted for free-trade agreements with Mexico and with the US.

a new sense of urgency is apparent. The continent (south of the Sahcra) is now covered by four trade agreements: ECOWAS in West Africa, formed from the expansion of the Francophone CEAO to include Anglophone countries; CEEAC in Central Africa, a revitalisation of the UDEAC arrangement of the 1960s; and the PTA, which includes countries that were in the defunct EACM as well as those in Southern Africa; and SACU, which covers those countries closely aligned with South Africa.[4] Several North African countries participate in the Arab Common Market, and in addition have formed various bilateral Arab Unions. The ultimate objective has been agreed in the OAU to work towards an African Economic Community, on the basis of such sub-regional groupings, by the turn of the century.

Discussions among the Pacific Rim countries are also aimed at establishing a regional trade identity. The only true Asian regional association, the ASEAN, has had a political and security focus. These countries have now agreed to establish an Asean free-trade area (AFTA), which would liberalise internal trade in 15 years. Broader economic groupings have been suggested, most prominently by Malaysia, as a way of reacting to European and North American regional blocs.[5] So far discussions held under the umbrella of the APEC have not proceeded far.[6] Issues of membership and objective seem at present insoluble.

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[4] An economic development grouping of states in Southern Africa, the SADCC, has recently agreed to set up the SADC, which would overlap in both substance and membership with the PTA. The PTA countries have proposed a merger between these two groupings.

[5] The Malaysian suggestion would have led to an East Asian Economic Group, comprising ASEAN, Japan and several other countries in the region.

[6] APEC was formed in 1989 to act as a forum for the discussion of trade issues in the Pacific Rim. It was not envisaged at that time as a trade bloc More recently, APEC has set up a Secretariat and called for a program to be prepared which would lead to regional trade liberalisation. APEC includes the US and Canada, who are not in favor of a preferential regional trade agreement

and a Uruguay Round outcome that will revive multilateral trade rules is still considered the most desirable option.

Proposition 2: Free Trade Areas are not a Substitute for the Multilateral System

It would appear from their prevalence that Free-trade areas fill some kind of political or economic need. The political attraction of these trade blocs is that they can be portrayed as both a step towards more open trade and as a line of defence against competitors. They will still be opposed by protectionist elements, including those parts of the bureaucracy that are threatened by freer trade, but are likely to have widespread support in the business community. As economic struggles replace the security tensions of the Cold War, alliances such as these may come to replace defence groupings as a focus for foreign policy. And in international fora, groups of states may come to play the role of the superpowers.

The economic case for free-trade areas is also a mix of liberal and neo-mercantilist objectives. The liberal case rests on the notion that the process of removal of trade barriers is easier in regional markets. This case is strengthened in such areas as services, where little multilateral trade liberalisation has been evident until now, and in intellectual property rights, where new codes of conduct are needed to deal with new technologies. Service trade may expand much quicker within regional markets, where regulations which govern labor and capital flows can be more easily coordinated. In these areas, several of the FTAs are pushing ahead of the Uruguay Round. Should the Round be

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in this area.

successfully concluded, their provisions will be less necessary.

The most significant area of regional liberalisation is likely to be investment. The attraction is that domestic firms can invest in the relative safety of the partner economy, to take advantage of cost differences (such as lower wage rates), whilst having the assurance of access for the finished product and less chance of discriminatory action by the host government. In such circumstances, trade is encouraged by the reduction of uncertainty, though the alternative of a multilateral agreement could still be better if it were possible. In general, such positive trade liberalisation serves to add to growth and employment, and to make better use of the world's resources. The phrase "open regionalism" has been coined to denote this plurilateral liberalisation.

The problems posed by such alliances stem from the defensive nature of much of trade policy, as it might become manifest in the use of trade restrictions at the regional level. It is a fine line between encouraging partner investment and discouraging investment from third parties. The existence of a regional agreement, for example, against expropriation of property held by foreigners implies that the excluded parties have less protection. Investment costs for those countries will be higher to cover greater risks. At times of economic hardship, such subtle discrimination can easily turn to blatant protection. This highlights the need for strong multilateral institutions and rules to oversee the trade blocs and their relationship to one another.

Proposition 3: Agriculture causes Problems for Free Trade Areas, and is Included Unwillingly

Agriculture has often been left out of FTAs, or treated in a way which has effectively excluded agricultural trade from their provisions. This may not be a possible solution in the future, if these arrangements take on greater significance in national trade policies. There are four major reasons to include agriculture in the provisions of an FTA. Firstly, exporter members will want access to importer markets for their agricultural goods. Only an alliance of all importing countries are likely to be able to ignore agricultural trade altogether. Secondly, food cost differences among countries within the FTA, arising from different agricultural prices could both distort trade and investment patterns and cause problems of wage comparability. Thirdly, if agriculture is excluded the food sector will tend to remain national in scope, as a result of different raw material costs and regulations, and may not be internationally competitive. And lastly, it is not GATT legal to exclude agriculture from free-trade agreements. Article XXIV requires that such agreements cover essentially all trade among the partners.

There are in essence only two reasons to exclude agriculture from the provisions of a free-trade area. Most domestic agricultural price policies require protection at the border in order to be effective. As a consequence, free trade poses some threat to the operation of such programs. And negotiations are likely to be complicated by domestic farm policy considerations. One cannot blame politicians from taking the easy way out when faced with negotiating regional access to cherished domestic agricultural markets.

In the treaty establishing the European Free Trade Association (EFTA) in 1960, agriculture was left out at the insistence of the British, who did not wish to weaken preferences for the Commonwealth (Canada, Australia and New Zealand in particular). The EFTA-EC bilateral trade agreements (1973), again left agriculture out, as no EFTA preferences were being eroded by accession of Denmark and the UK to the EC. In the more recent negotiations leading to the creation of the European Economic Areas (EEA) in 1992, agriculture has been largely left out of the EC/EFTA internal market agreement, to the chagrin of the Spanish who would like to have had better access to the rich Nordic and Alpine markets for mediterranean products. A series of preferential quotas is included in the EEA which only serve to highlight the current fragmented nature of the market for many agricultural goods in EFTA.

The various Latin American free-trade agreements, including the LAIA, the ANDEAN PACT, MERCOSUR, and CARICOM, all have essentially focussed on industrial products. The bilaterals being negotiated under the framework of the Enterprise for the Americas Initiative (EAI) also are light on agriculture. In Asia, regional groupings are less common, and hence have less direct influence on agricultural policy. ASEAN has operated a collective agreement on food security, involving the sharing of rice stocks at times of shortage, but otherwise has had little agricultural (or trade) content. Recently, ASEAN countries have agreed to set up a free-trade area (AFTA), but agriculture is to be largely excluded.

African free trade agreements have generally included provision for freer trade in agricultural goods, as these cover a large share of trade for the countries involved. However a variety of revenue duties, coupled with the para-statal control over many of the export commodities, have made agricultural trade less than free, even when no tariff restrictions apply. Instead the emphasis has often turned to the coordination of agricultural investment, and to common approaches to prospective donors.

In North America, CUSTA (1990) included agriculture in the tariff-cutting activity, but not in the non-tariff barrier removal.[7] Neither the US nor Canada thought of the other as a big potential market, and the GATT Round seemed to be taking care of agricultural trade issues. The NAFTA (1992) also shows signs of being overshadowed by the Uruguay Round: it includes a set of trilateral provisions of a largely exhortative nature on the need to use less trade-distorting domestic policies and abstain from export subsidies. Market access is improved by the provisions of two bilateral (US-Mexico and Canada-Mexico) access agreements for agricultural products (to supplement the US-Canada bilateral that already existed). A schedule of tariff reductions over the next decade will give Mexico better access into the US and Canadian agricultural markets, and vice versa. Non-tariff barriers are also to be phased out on US-Mexico trade, leading to a relatively free internal market for grains, oilseeds, meat and horticultural products. As an exception, Canada gets to keep import quotas on dairy and poultry products (the "supply managed" commodities), at least until forced by a GATT agreement to convert them to tariffs.

The treatment of agriculture in free-trade areas thus lags well behind other sectors in its liberal influence. Domestic policies have generally prevented an open border approach to market integration. Perhaps only the Closer Economic Relations (CER) Treaty between Australia and New Zealand fully incorporates agriculture, but that was made easier by the sharp reduction in the level of protection of the sector in New Zealand in late 1980's.

Proposition 4: FTA members will have to modify their agricultural policies to

[7] The exception to this was the liberalization of Canadian cereal import licensing.

accommodate free intra-bloc trade

Intra-bloc agricultural trade problems arise for the same reasons as with the GATT. Domestic programs require border measures to be effective; removing these border measures would make domestic programs difficult to work. The ...stion is how to allow free trade within an FTA without eliminating domestic ...ograms.

Free trade is an imprecise concept. It certainly implies the absence of deliberate tariff barriers and such non-tariff barriers as quotas and parafiscal taxes. It usually means the absence of discriminatory policies that treat imported goods less favorably than those of domestic origin. In its strictest sense it would also include the removal of all policies that give any form of assistance to domestic firms, on the principle that the playing field was not truly level. Taken to its extreme, provision of most public goods would be effected, as the quantity, quality, and method of financing of such government activities undoubtedly influence competition.[8] Governments, however, are not likely to buy the argument that a free-trade commercial policy involves giving up all domestic sectoral, regional and industrial policies. In practice, the question is how to constrain policies that give a marked incentive to expand the production, or reduce the consumption, of a product of export interest to a trading partner.

A classification of policy instruments permits identification of those likely to be of particular relevance in free-trade area talks. For this purpose it is useful to start with a distinction between "coupled" and "decoupled" poli...

[8] If one adds free trade in services, another set of government regulations could be considered contrary to free trade. Barriers to service trade are generally of the form of regulations on labor mobility, rules of establishment, fiduciary control of financial services, and other types of regulations usually deemed "domestic."

instruments. In this context, a "coupled" policy rewards (or taxes) producers or consumers on the marginal unit of production or consumption. Output or use decisions, therefore, are directly impacted by the policy.[9]

Four combinations of producer and consumer policy types are possible, as shown in Figure 1. Policies that are coupled on the producer side are likely to cause the most problems for intra-block trade. These include primarily the set of policies that operate at the border, which are coupled to both production and consumption decisions. Policies decoupled on the consumer side include various producer subsidies paid in a way that allows market prices to find their own level. These will be somewhat less contentious, but still raise issues of competition among producers. Producer-decoupled programs include coupled consumer taxes and subsidies, which are unlikely to be of major concern in an FTA, and those fully decoupled instruments that do not directly affect market price and hence are likely to be broadly acceptable to all of the trading partners.

One would expect the issue of direct trade policies to be the most immediate concern in FTAs. The problem will be apparent as a conflict between protected domestic producers and those wishing to gain access to that market through the provisions of the FTA. The natural focus of negotiations in the case of tariff protection is to agree on a reduction on such tariffs on intra-bloc trade, leaving members to run their own external commercial policy. The tariff reductions can be subject to safeguard provisions, which can act to "snap-back"

[9] This definition of a coupled policy is less rigorous than others that can be suggested. For instance, lump sum payments do not affect marginal decisions directly but may be enough to keep a producer in business, borrow to finance expansion, and choose one product over another. Too strict a definition of decoupled policies is probably unconstructive in the context of FTAs: too few policies would qualify, and the attempt to modify national policies could be abandoned.

Figure 1: Classification of Instruments According to Degree of Coupling

	Producer Coupled	Producer Decoupled
Consumer coupled	Incompatible with FTA Allowed on third-country trade -Import taxes, levies -Import quotas -Export subsidies -Voluntary export restraints -Home market schemes -Producer-financed export subsidies State trading	Likely to be tolerated in FTAs -Consumer subsidies -Storage subsidies (consumer level)
Consumer decoupled	Likely to be challenged in FTAs as distortion of competition -Producer subsidies -Deficiency payments -Storage subsidies (producer level) Set-aside payments $(P_i - P_w) . Q$	Allowable under FTAs -Food stamps (general) -Crop insurance -Hectarage payments -Set-aside payments $(P_s - P_i) . Q$

$(P_i - P_w). Q$ refers to the part of set-aside payments that stimulate output above world prices, and $(P_s - P_i). Q$ is that part which has no effect on output. See text for an explanation of these terms tariffs if imports rise too fast. In the case of import quotas one would expect the relaxation of quantitative restrictions on partner trade over a period of time. Domestic pressures will try to influence the time period allowed for adjustment though this may be unrelated to the actual time needed for such adjustment. Firms will be keen to protect the value of their capital investment; a long transition period preserves for a time the stream of protected receipts and hence presents a free fall in asset values.

Export subsidies are also likely to be objectionable to producer interests in an FTA, on grounds that competition is distorted. Governments in general will have less difficulty reducing export subsidies on internal FTA trade, despite the fact that such subsidies offer protection to producers.[10] It is somewhat easier for an industry to claim protection against imports than to argue for export assistance. Quantitative controls on exports within the bloc, such as might be used to keep prices down in times of shortage, can also be outlawed with relative ease. Voluntary Export Restraints (VERs) have become a part of the commercial armory of a number of countries: it would seem natural that FTA partners remove all VER arrangements between them, perhaps after a transition period.

Among other export-related policies that are likely to cause problems for FTAs are home-market schemes (where a higher domestic price gives an implicit export subsidy as a result of revenue pooling) and "producer-financed" export subsidies, paid from a producer levy rather than from the taxpayer.[11] Such

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[10] On occasions an importing country may wish to keep the advantage of subsidized imports from the partner, at the expenses of domestic producer interests. This could be true, for instance, in the case of Mexican attitudes toward US government credit guarantees on sales of dairy and grain products to Mexico.

[11] This instrument should be more properly called a consumer-financed export subsidy, as it can only be profitable for the producer to sell more cheaply abroad if the domestic price is raised above the world market price. As

policies distort competition and will be targets for negotiation. However, in so far as they are run by marketing boards there could be considerable resistance to change.

This problem of what to do with institutions that run policies counter to an FTA arises also in the case of state trading. A parastatal importer can offer protection without the need for a tariff or explicit quota. The effective quota is the amount imported, which can be less than would have come in under free trade, and the implicit tariff revenue is the profit made by reselling on the domestic market. Export agencies also can influence traded quantities, often giving an effective subsidy through trading losses. A country may be reluctant to give up its cherished institutions on account of an FTA: in practice, some accommodation will have to be found to prevent conflicts arising within the FTA from state trading activity.

Producer subsidies raise problems for FTAs only slightly less serious than direct trade barriers. Competitors in other countries are likely to challenge producer subsidies as distortive of competition. The economic case for the removal of such subsidies is not clearcut: the policies may be desirable responses to divergences of a specific national character. In terms of political economy, the success of the FTA may hinge on the willingness of governments to give up the right to distort competition even when national conditions might warrant such policies.

Deficiency payments are a special breed of producer subsidy, triggered by the relationship between market prices and a pre-set guaranteed price. They add stability to farm prices (if not incomes) and are generally considered by

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with the home market scheme, such producer-controlled policies require import restrictions to operate and are usually associated with parastatal marketing boards.

recipients to be the next best thing to adequate market prices. To give up these policies in an FTA may prove difficult. It is more likely that attempts would be made to "decouple" such payments, as has been done for the purposes of control of domestic spending.

Storage subsidies (at the producer level) pose similar problems, but are in general likely to be less provocative: they act to remove surpluses when prices are low and may be deemed helpful to the partner country in the FTA. The subsidy element in set-aside programs is, however, likely to be contentious. Set-asides are usually ways of restraining the quantity of output that can benefit from support prices. They should, therefore, be judged as a part of a producer subsidy program. One can conceptually distinguish between that part of a set-aside payment that is production-neutral and that which is in effect a production-stimulating subsidy.[12] The US-Canada Free Trade Agreement attempted to deal with this issue in the context of opening up Canadian markets to US grain.

Consumer subsidies are unlikely to generate significant problems within an FTA, even though they may distort competition. There is enough of a mercantilist flavor to most FTAs to welcome any trade-expanding measure. Schemes that encourage storage (at the wholesale level) in general will also be found unobjectionable. Stability from such storage will benefit all partners.

Similarly benign are programs that are effectively decoupled from output and consumption decisions, such as food stamps (which act much as an income

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[12] If P_s is the (marginal) support price, P_w the world price, and P_i the price at which the actual output would be the same as that with the policy (the "incentive" price), then $(P_i - P_w)$ is the price incentive and $(P_s - P_i)$ is a production-neutral subsidy. See Carol Bray, Tim Josling and Jay Chorlow "Adjustments for Set-Aside Acres in Agricultural Trade Agreements: An Example from the Canada-US Trade Agreement," Canadian Journal of Agricultural Economics, Vol. 40, 1992, p.25.

supplement) and crop insurance (so long as it is not commodity specific). Payments per hectare, such as is envisaged in the MacSharry proposal for the EC, may raise some questions in an FTA, but if truly decoupled from current output decisions they may have a minimal impact on competition. The decoupled element of set-aside payments could also be deemed to be non-distorting within an FTA.

Proposition 5: FTA members will also change their third country trade policies over time

The problem of domestic instruments as barriers to market access for FTA partners is the focus of most attention in free-trade negotiations. But an equally important issue that has received remarkably little attention is the impact of freer intra-bloc trade on the effectiveness of trade policy instruments that might be used by member countries on third country trade. What commercial policies can survive in an FTA? On the face of it, members can remove those policies that cause the most trade friction within the FTA and still maintain their individual policies against non-members. Figure 2 shows the range of policy instruments where the trade measures apply only to third-country trade But even if only the less disruptive policies were allowed to stay, significant changes in their effectiveness are apparent. The feasible policy set in an FTA is much smaller once protection against partner trade is removed. The loss of policy effectiveness can be illustrated by considering the various instruments in the presence of free partner trade.

The problem of disparate tariffs on third country trade among FTA members is well known. Trade can be "deflected" through the country with the lowest border protection and dilute the protection in the other countries. It is normal

Figure 2: Impact of FTA on Effectiveness of Policy Instruments

Policy	Impact of FTA
Tariff on 3rd country imports	tariffs above lowest partner level become ineffective
Quota on 3rd country imports	quotas become ineffective
Export subsidy on 3rd country trade	subsidies become more expensive
Voluntary export restraint on 3rd country trade	restraint becomes ineffective
Variable import levy on 3rd country trade	stability property lost
Government financed storage scheme	storage scheme becomes less effective
Quantitative limit on domestic marketing or production	quota becomes ineffective as price raising device
Deficiency payments	not directly affected: cost may be raised or lowered
Consumer subsidies	not directly affected: cost may be raised or lowered
Crop insurance	not affected
Hectarage payments	not affected
Food stamps	not affected

in FTAs to deal with trade deflection by means of rules of origin. To qualify as "internal" a product must have undergone a substantial transformation (or acquired a particular value added) in the partner country. Unfortunately, this remedy is of limited use for agricultural products. Rules of origin are meaningless for a homogenous good: even if one could trace the origin of a particular bushel of wheat, national supplies are fungible. The low-priced country would import its consumption needs to free up exports to the high-priced market. Such arbitrage could only be stopped by interfering with intra-bloc trade.

Similar problems apply in the case of import quotas on third country trade. One country cannot effectively maintain such quotas if its partner with free access does not. Import quotas can be fully effective only if "regionalized" to apply to both markets--in effect the introduction of a "common policy"--just as tariffs will only be fully effective if harmonized. Third-country import policy can still be nominally independent in an FTA, but in practice pressures will mount for coordination in the case of homogenous products.

Export policy fares ' . better. An export subsidy (on third country trade) may survive the negotiation of an FTA. But if there is free access into the market of the subsidizing country and supplies are fungible, production from the non-subsidizing country will flow to the subsidizing partner and cause the policy to collapse. Voluntary export restraints suffer the same fate: there is little point in negotiating such restraints with third country suppliers at the front door if the back door is open. Once again, the solution is either common policies or the abandonment of the instruments. Home-market schemes and "producer-financed" export subsidies also lose their efficacy in a situation of free partner access, even if restricted to third countries. The ability of the marketing board to operate such schemes is impaired by lack of control of all sources of supply. Consumers can in effect choose not to subsidize exports: they merely buy partner products.

Also influenced by the operation of an FTA, as market access within the area is improved, is the mechanism of the variable levy. If one member of the FTA has a fixed tariff and another a variable levy, the fixed tariff will come to dominate the levy. Prices in the country previously protected by the levy will follow the world price plus the fixed tariffs, with arbitrage among the markets. Other stability devices (such as variable export subsidies) suffer the same fate. It is difficult for one country to stabilize its market if it has free trade with a less stable partner. Instability will flow across the border. This will tend to lead to either a departure from the FTA principles or a common stability policy.[13] It follows that storage policies will also either become unmanageable (as are partner attempts to stabilize the whole FTA internal market) or coordinated. Independent stability policies will not survive a regional free trade regime.

Proposition 6: Domestic Policies in FTA Members are likely to Change even when they do not Conflict with Intra-Bloc Trade

The countries within an FTA may accept that their powers to run independent policies on third country trade are de facto restricted: surely they can run domestic policies to maintain farm incomes. Take as an example the control of domestic supply through production or marketing quotas. Free partner trade will not in itself prevent such quotas from operating. The effectiveness of such

[13] To the extent that production fluctuations within the FTA offset each other, stability may be increased with free trade among partners.

quotas, however, will be significantly limited. It is clear both from economic analysis and trade policy practice that domestic supply controls need trade measures as support. If substitute production can be freely imported from an FTA partner, the production control will be ineffective in maintaining price.[14] This is the reason behind the exception in the GATT to the rule of "tariffs only" (Article XI), which allows quantitative restrictions when domestic production is controlled. It also lies behind the use of import quotas under Section 22 of the US Agricultural Adjustment Act (as amended) which mandates such action in support of domestic policies. FTAs put to the test the issue of import barriers in support of domestic quotas.

The relationship between FTA rules on internal trade and the ability to run domestic subsidy programs is less clearcut. Such subsidies could be ruled out on competition grounds, as indicated above. But those that survive might be weakened by the free access provisions of the FTA. Essentially, the impact on such policies depends upon the trend in market prices. If freer trade with partners reduces market prices, the cost of deficiency payments could increase. But free trade could also increase market prices, if export opportunities are opened up. In this case the cost of deficiency payments in an importing country could go down. Less stable market prices, following from the greater market access, will also cause the cost of such policies to fluctuate. But the market price in the FTA could also be more stable as a result of freer trade. Consumer policies could benefit from more open access to partner supplies: food stamp programs and those that fix maximum prices for consumer foods will be less costly

[14] One could still control production to limit government expenditure. Political support for such limits could erode, however, if it was clear that no price enhancement was being achieved.

to run with lower cost supplies. In general, if the consumer and producer subsidies survive the "competition" test of the FTA, they probably can survive the arbitrage that would follow the opening up of market access.

Decoupling such policies from output decisions was suggested as the response to the competition issue, and this would tend to free farm incomes from market prices. The set of decoupled policies discussed above will generally be left unaffected by freer intra-bloc trade. Crop insurance, hectarage payments (for the reduction in price support, tending the land, or abstaining from chemical dependency) and food stamps can all thrive in an environment of free trade. In some cases, there might be higher costs, if market prices fell or were more unstable, but such extra costs in effect would be compensation for the beneficial impact of lower cost supplies. It is no coincidence that the same set of policies are being proposed for the "green box" in the GATT negotiations. Policies that are consistent with free regional trade are also likely to be acceptable at the international level. They are not only consistent with market access and competition needs of an FTA, but also they, almost alone among existing policies, can be run effectively in the presence of free trade among partners. The reinstrumentation of policies towards decoupling and targeting may be the only way for farm groups to preserve benefits without facing head-on the movement to regional free trade.

Proposition 7: FTAs can be Complementary to a GATT Agreement on Agriculture: Each can Help the Other

The difficulties of including agriculture in an FTA, taken together with the realities of arbitrage in an FTA, as explored in the last two propositions, imply three options for agricultural policies. They can be preserved from the discomfort of regionally free trade by the exclusion of agriculture from the major FTA provisions, by allowing border interventions and discriminatory domestic programs to continue. As an alternative, there could be a movement toward uniform bloc policies, involving "common policies" or coordinated national policies and national treatment for partner supplies. Or the members of the free-trade area could change to policies which rely on simple border tariffs and decoupled payments.

In this connection, it is interesting to consider the linkages between the GATT approach and these internal FTA developments. Exclusion of agriculture from FTAs is not a long-lasting solution, and threatens to create the same conflicts within FTAs as it has in the GATT. Movement toward common bloc agricultural policies is a real possibility, which reinforces the need to have a strong GATT to referee the development of such policies. The movement toward decoupled payments would be made much easier by a GATT agreement along the lines of the Dunkel Draft, as the move to "green box" payments would simplify the negotiation of FTAs. A favorable GATT outcome would make negotiation of these agreements much easier. In the NAFTA large parts of the GATT text, on the definition of acceptable subsidies, etc., could be included which would have to be negotiated separately if there were no GATT deal. In EC enlargement, one could envisage transition periods for tariffs and green-box payments, avoiding the confusion of policy harmonisation of previous enlargement exercises.

Proposition 8: Free-trade Areas will not Solve the Problems of World Markets

The final set of issues relates to the links between the intra-bloc treatment of agricultural trade and policies and the situation on world markets.

Among the analytical issues in this context are the impact of regional free trade on world market price levels and stability; the conditions under which trade diversion may impact countries not part of trade blocs; the extent to which regional solutions assist in the negotiation of multilateral rules; and the importance of multilateral rules for guiding the conduct of inter-bloc trade in agriculture.

These questions do not have a straightforward answer. The significance of the treatment of agriculture within an FTA on outsiders depends on a number of factors. Paramount among these are protection levels in the FTA countries and the trade balances of the participants. Before looking at the issue of actual trade blocs and their impact, some clarification of the expected direction of that impact is useful At the risk of some tiresome taxonomy, this is attempted below

The range of different rade outcomes can be seen by imagining four typical countries, each a candidate for a two-country FTA (see Figure 3).[15] Countries A and B are protectionist, one an exporter and the other an importer, while Countries C and D are a liberal importer and exporter, respectively.[16] One can

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[15] The discussion of this section is limited to two-country FTAs, ie. bilateral trade agreements. The taxonomy would quickly get tedious if all possible multilateral arrangements were to be included. However, the results from the two-country examples are illustrative of the range of possibilities in the multicountry cases. It is additionally assumed that all partners have roughly equal weight in the formation of the FTA. Obviously, a dominant partner could impose the agenda and define the trade concerns of an unbalanced FTA. A particular form of bilateral agreement is the "hub-and-spoke" model, where a large "hub" country (say the US, the EC or Japan) negotiates individual bilateral agreements with a number of smaller countries, which may or may not have an preferential access to each other's markets. It is tempting to see the hub-and spoke system as merely a series of independent bilaterals, but as seen from the hub the arrangements are more like a multicountry FTA.

[16] The terms exporter and importer refer to the trade balance for a particular commodity. The comments on internal and external problems should be interpreted accordingly.

Figure 3: Categorization of Possible FTAs by Trade Regime and Trade Balance

Type of Country	Trade Regime	Trade Balance	Examples
A	Protectionist	Importer	Japan, ROK
B	Protectionist	Exporter	EC, US, Canada
C	Liberal	Importer	Mexico, Chile
D	Liberal	Exporter	New Zealand, Australia
Type of FTA	Internal Problems	Trade Creation	Trade Diversion
a) Likeminded FTAs			
AA	concern over deflection	no	no
BB	concern over subsidies	no	no
AB	conflicts over access	yes	yes
CC	no internal problems	no	no
DD	no internal problems	no	no
CD	no internal problems	no	no
b) Contrarian FTAs			
AC	concern over deflection	yes	no
AD	conflicts over access	yes	no
BC	concern over subsidies	no	yes
BD	no conflicts	no	yes

therefore define six "likeminded" FTAs, which match either protectionist countries together or involve only those with liberal trade policies. In each case one can ask what internal problems are likely and what might be the outside interest. Internal problems are most likely among the protectionist FTAs. Two high-priced importers (an AA FTA in Figure 3) will tend to have conflicts over trade deflection, each cautious about weakening their own internal market price. One would expect the protection levels in these countries to move together over time as a way to avoid such problems. It is also likely that pressures will mount to free up internal trade. This could cause the bloc as a whole to move toward lower levels of protection, and some trade creation could occur. Significant trade diversion is inherently unlikely in markets where both countries are importers, but the lowering of support levels could have some beneficial impact on third countries.[17] An alliance between two high-priced exporters (a BB FTA in Figure 3) may also lead to internal conflict, this time over the level of subsidies in each member, and there might be pressures to reduce such subsidies. However, there is no clear presumption that any significant trade creation or diversion will occur as a result of pressures within the FTA.

Trade impacts on the rest of the world are more likely if the partners have different trade interests and commodity balances. A protectionist importer and a high-cost exporter (an AB FTA) will undoubtedly try to expand internal trade.

[17] The analytics of trade creation and trade diversion, and its interpretation in non-tariff situations, is discussed in the Annex. Trade creation is usually defined as an increase in imports in the importing partner; trade diversion refers to the switch in the source of supplies away from third country trade. In the present context, trade creation can be taken to mean a reduction in protection levels as a result of the FTA and trade diversion as a reduction in demand by the FTA from the rest of the world (or an increase in supplies). Thus trade creation raises "world" prices and trade diversion lowers them.

at the behest of the exporter, though the importer will try to resist this pressure. Trade expansion will tend to be positive for agricultural markets, but the main benefits will be captured by the exporting partner. Trade diversion is likely to swamp any positive impacts from freer FTA access. Free trade agreements among "liberal" countries (CC,DD and CD FTAs) are likely to be relatively benign. With low trade barriers and few export subsidies, and with price levels close to world market levels, the internal improvement in market access will have little effect on collective balances with the rest of the world.

A different set of responses can be expected if protectionist and liberal countries are thrown together in an FTA. These "contrarian" FTAs are likely to have somewhat different approaches to the inclusion of agriculture in intra-bloc free trade. A protectionist importer paired with a liberal importer (an AC FTA) will be primarily concerned with trade deflection through the liberal partner's markets. Agriculture may well be left out of the agreement, as a way of avoiding this problem. A protectionist importer paired with a liberal exporter (an AD FTA) will be more likely to include agriculture in the FTA agreement. The exporting partner will argue for more liberal access and lower prices in the importer as a condition of membership.[16] Trade creation is likely, but third countries may gain little: the improved access would go to the exporting partner, as envisaged in the intra-bloc trade deal. A liberal importer paired with a protectionist exporter (a BC FTA) will be concerned over the level of subsidies employed by its high-priced partner. Competition rules are likely to be high on

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[16] The issue of a liberal exporter joining an already established union between protectionist importers is of some interest. Will the exporter be able to change the trade stance of the importers? Or will the exporter be content to turn protectionist, knowing that the size of the "home" market will be increased by such a policy? The Netherlands faced this dilemma when it joined the Belgium Luxembourg Economic Union (to form the BENELUX Union) in the immediate post war period.

the internal agenda. However, internal trade may not increase, and the main impact could be on third country trade, if the liberal importer becomes a "trojan horse" for reduction in internal prices in the exporter. In this case there would be negative trade "diversion" which would be positive for world markets as subsidized exports were reduced. Protectionist exporters paired with liberal exporters (a BD FTA) also could catch a dose of liberalism, as the process of arbitrage weakens the ability of the high cost producer to dump on world markets.

This set of possibilities would suggest that the impact on any third country is crucially dependent on the nature of the countries forming the FTA. It is useful to consider some of the major commodity markets and the situation in existing trade blocs and regions discussing such arrangements. This is attempted in Figure 4, which indicates in summary form the net balance of some of the major (mainly developed country) trade groups. The major trade problems of agricultural markets are represented in this matrix. The EC, North and South America, and Australasia are net exporters of wheat, seeking access into somewhat protected markets in East Asia (and in other regions not in the Figure). It follows that the wheat market is not likely to be benefitted by alliances between low-cost exporters (as in NAFTA) and only somewhat indirectly by an FTA between the EC and other European countries.[19] If East Asia joined with either Australasia or North America (or even South America), one might expect some net liberalization of world trade. But most of the improved access into protected importer markets would be reserved for partner suppliers. The key relationship between the competitive exporters and those who export with large subsidies looks

[19] An exception could be increases in wheat exports from Argentina to Brazil, as a result of a bilateral between those two countries. See Barry Krissoff and Jerry Sharples "Preferential Trading Arrangements: Wheat Trade in Western Hemisphere Countries," (mimeo) 1992.

Figure 4: Commodity Balance and Regional Trade Blocs

Commodity	South America	North America	European Community	EFTA and EE	East Asia (inc Japan)	Australia & New Zeal.
Wheat	+	+	+	=	-	+
Rice	=	+	=	-	+/-	=
Corn	+	+	+/-	-	-	=
Oilseeds	+	+	-	-	-	=
Dairy	=	=/-	+	+	-	+
Meat	+	=	+/-	+	-	+
Sugar	+	-	+	=	-	+
Fruits and Vegetables	+	+	-	-	-	+

Key: + indicates export surplus

- indicates import deficit

= indicates approximate self-sufficiency

+/- indicates import possibility with lower protection unlikely to be resolved in the context of an FTA.[20]

The situation for rice is somewhat similar, since the East Asian market holds the key. In this case, the key relationship would be between the US and Japan. If free trade were proposed between the two, the issue of rice would have to be faced. Any liberal solution to this problem would have world market benefits, even if the US rice producers get the major benefit. Corn trade into Asia is less restricted. In this case only a US-EC free trade compact is likely to have major impacts on world markets, although internal impacts of FTA arrangements could be significant for corn-consuming economies.[21] Oilseed markets are also likely to be only affected by free trade agreements between the US and the EC, although freer trade in oilseeds between South America and the EC would have an impact on world prices.

The situation is somewhat different for dairy products and meats, where the US is not a major exporter. In the case of dairy, it is not easy to see an FTA putting significant pressure on dairy protection in the EC, except as a result of some EFTA surpluses. Australia and New Zealand once had an FTA with the UK, which stimulated beef, sheep, and dairy exports to that country. New Zealand has special access still in that market. But nothing like a free-trade pact between the EC and Australasia is likely to bring relief to the dairy market. The beef and sheepmeat markets could be helped by regional free trade agreements, as between Australasia and East Asia.

Sugar is one of the few commodities in which regional free trade could take

[20] It seems safe to assume that in any FTA between the US and the EC, the Community would ask for an exclusion of agricultural trade. Inclusion of such trade would have major repercussions for other countries.

[21] This is particularly true of Mexico in the context of the NAFTA, where inclusion of corn as an item to be liberalized will have major impacts on the rural economy .

significant pressures off the international market. In particular, the US market could expand to absorb exports from the Caribbean, Central and South America. At present, trade policy is designed to protect the workings of domestic price support systems. If this protection were removed in regional negotiations (or in the GATT), there would be benefits to world markets.[22] Similar benefits could be achieved in some fruit and vegetable markets, where regional trade flows are both complementary and significant in terms of world trade. The trade relationships between the EC and Eastern Europe and the Mediterranean, and between the US and Central and South America, each have the potential for impacting the world markets for certain fresh fruits and vegetables.

Beyond these commodity-specific effects, the most important link between FTAs and world agricultural markets is the impact on national domestic policies. At present the trade implication of such policies is being discussed in the GATT Uruguay Round The argument in this paper is that a similar outcome may be possible with the full inclusion of agriculture coupled with a strict adherence to the principles of free access within FTAs.

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[22] See Steven Neff and Timothy Josling, Economic Effects of Removing US Dairy and Sugar Import Quotas, NCFAP Discussion Paper No FAP 92-01, Resources for the Future, Washington, D.C., 1991.